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THE BLACK HOLE. MONEY CREATION, QE AND INFLATION

ECONOFICTION ASSET INFLATION, CAPITAL, CENTRAL BANK, FINANCE, INFLATION, QE

Is QE money printing or an asset swap?

Yes and no.

Academics and bankers have long disagreed about money creation, use and even measurement. Back in the 1970s, for example, estimates of the euro-dollar money supply were incredibly difficult to calculate. For this reason, the Federal Reserve stopped measuring the money supply and later in 2006 also stopped calculating the M3 money supply. It simply became too difficult for the government or private institutions to understand what money is or how much money there is.

Greenspan explained in a 1996 speech:

Basically, money – as a store of value and a medium of exchange – is the lubricant that enables a society to organize itself to achieve economic progress. The ability to store the fruits of one's labor for future consumption is necessary for the accumulation of capital, the spread of technological progress and, as a result, a rising standard of living.

In this context, the general price level, i.e. the average exchange rate of money against all goods and services, and its change over time plays an extremely important role in any society, as it influences the nature and extent of our economic and social relations over time.

It is no wonder, then, that we are subjected to endless scrutiny at the Federal Reserve, the nation's central bank and ultimate guardian of the purchasing power of our money. Indeed, it would be foolish for it to be otherwise.

So the Fed is crucial to money – and therefore “independent,” because a dependent central bank is subject to the whims of politicians and will monetize government spending. As an independent entity, the Fed is protected from this undue influence and therefore immune from causing disasters and can foresee any problems in the monetary system, right?

Most textbooks on monetary economics will tell you:

Deposits that enter the banking system are stored as a kind of “reserve”. In addition to this reserve, new loans are created, in a leveraged ratio, so that 10 dollars in deposits allow the creation of 100 dollars in loans. The more deposits received, the greater the banks' credit capacity.

Bank reserves are the main capital on which banks rely and are set at a fixed amount by the central bank. These reserves are multiplied by a static variable – the “money multiplier” – by the base money. So when central banks engage in QE, more money is created. Lending takes place directly on the basis of reserves.

Both are wrong.

In today's economy, most of the circulating money supply is in the form of deposits, which are mainly held at banks. However, there is a widespread misunderstanding about how these bank deposits are created. They are primarily created when commercial banks make loans. Every time a bank grants a loan, it simultaneously creates a corresponding deposit in the recipient's bank account.

When households increase their savings in bank accounts, these deposits are essentially deducted from potential deposits that would otherwise have been allocated to companies for the purchase of goods and services. Saving in itself does not lead to a direct increase in deposits or loans.

To summarize the Keynesian view of banking, the quantity of reserves must act as a restrictive factor on lending, and the central bank must have direct control over determining the quantity of reserves. Although money multiplier theory is a useful introductory concept in economics textbooks to illustrate banking, it does not accurately represent the actual process of money creation. In practice today, central banks generally set monetary policy by influencing the cost

of reserves – particularly interest rates – rather than by directly controlling the quantity of reserves.

In reality, reserves do not serve as a multiplier for lending. Similar to the relationship between deposits and loans, the correlation between reserves and loans generally works in the opposite way to how it is presented in economics textbooks. Banks generally make their lending decisions based on profit opportunities, which are influenced by the interest rate set by the central bank. The amount of reserves instead increases balance sheet capacity, so that a bank has a larger stock and potential for lending, but without profitable lending opportunities this remains unutilized.

The money supply (M2) consists of two main components: Bank deposits, which are essentially promises made by commercial banks to households and companies, and currency, which primarily represents central bank obligations. Bank deposits make up the overwhelming majority, 97%, of all money in circulation.

This is important because the M2 money supply is what is available for spending in the real economy. It is cash in circulation, the amount of which has a direct impact on prices and therefore on inflation. Observing M2 is important to understand how the real economy works. M2 is the Federal Reserve's estimate of the total money supply – including all the cash people have on hand and all the money deposited in checking accounts, savings accounts and other short-term savings vehicles such as certificates of deposit (CDs). Balances in retirement accounts and time deposits over \$100,000 are not included in M2, according to the Fed.

Commercial banks generate money in the form of bank deposits when they make new loans. When a bank makes a loan, such as a mortgage to buy a house, it does not usually give the borrower thousands of dollars worth of physical banknotes. Instead, the bank increases the borrower's account balance by a bank deposit equal to the amount of the mortgage. This immediately creates new money.

If this process continues, the money supply and the debt burden grow together, increasing asset values and keeping latent inflation low throughout the system. Due to the structure of this system, it is almost impossible for prolonged deflation to occur, as this means that loans default and money is destroyed, leading to a fall in asset values and thus risking the collapse of banks, only a fraction of which hold reserves.

The newly generated deposits increase the assets of consumers, i.e. households and companies, while the new credit increases their liabilities. This leads to new money creation in the broader sense. Similarly, both areas of the commercial banking sector's balance sheet expand when new money and new credit are created.

Although new broad money is created on the consumer's balance sheet, this occurs without an immediate adjustment to central bank reserves. As we mentioned earlier, the increased deposit base may cause banks to want or need to hold more central bank money to meet withdrawals or interbank payments – but this does not mean that these reserves are created immediately.

Bank reserves created by the Fed as part of its quantitative easing programs are by definition not spent in the real economy. They rotate on the balance sheets of financial institutions and

are used for collateral and funding arrangements to purchase securities or to meet regulatory requirements.

Fed reserves are an unsecured liability of the Fed that can only be held by companies that have an account with the Fed. It can be thought of as a checking account at the Fed, except that deposits in the account can only be used to make payments to entities that also have a checking account at the Fed. By and large, only depository institutions such as commercial banks or credit unions are authorized to hold accounts at the Fed. But there are other important institutions such as the U.S. Treasury, government financial institutions like Fannie Mae, and clearinghouses like the CME. When these institutions make payments to each other, they pay with reserves.

Bank deposits are an unsecured liability of a commercial bank that can be held by anyone who has an account with the commercial bank. Bank deposits make up the majority of what people refer to as “money”. When you log in to your online bank account, you can easily see how many bank deposits you have – how much your bank owes you. Bank deposits are created when a commercial bank buys assets or makes loans. When a bank transfers 1 million dollars to you, it simply credits 1 million dollars to your bank account. A commercial bank does not lend bank deposits, it creates bank deposits. However, the commercial bank must ensure that its deposits are backed by sound credit and that it has sufficient liquidity to make payments to other commercial banks.

Why is QE “sometimes” money printing and other times not?

The missing key is the Treasury.

When the Fed engages in QE, it creates a bank reserve and swaps it for an asset on a commercial bank's balance sheet, say a Treasury bond, thus increasing its own assets and liabilities and indirectly the assets of the entire banking system by providing new reserves that can add value to other financial assets and thus increase the value of the assets. This swap has no impact on the real economy as bank reserves are exchanged between two entities that do not (and cannot) use bank reserves to purchase goods/services. Thus, there was a massive increase in the Fed's balance sheet in 2008 when the Fed spent trillions in new reserves to buy up assets – but those reserves were trapped.

There is no direct link between the two levels – with the exception of the Treasury General Account (TGA). This is an account held by the US Treasury at the Federal Reserve. It serves as the government's primary checking account and plays a critical role in managing government finances – disbursing funds for various government expenses, such as payments to government agencies, debt service and federal payments like Social Security benefits and tax refunds.

The TGA balance can fluctuate depending on the government's financial activities. When the government runs a budget surplus, the TGA balance increases as it accumulates excess funds. Conversely, if the government runs a budget deficit, it can draw on TGA funds to cover its spending. In 2020, the account reached a record high of 1.8 trillion dollars before falling to 80 billion dollars. On May 31, 2023, just before the debt ceiling was raised, it reached a low of \$48 billion, forcing the Treasury Department to take extraordinary measures to avoid default.

When the Treasury auctions bonds, it sells them (indirectly, through the primary dealers) to banks, financial institutions or individual private investors. When banks or financial institutions buy, they do so with bank reserves – their form of liquid assets.

All funds in the TGA are by definition bank deposits that can be spent in the real economy. But these deposits can also be used to buy securities, as was seen in 2008.

Under the TARP program and other federal programs, the US Treasury bought toxic assets from the financial system so that these deposits were repatriated and thus did not trigger the dreaded inflation caused by the first wave of QE after 2008. However, this is not the main purpose of the Treasury. The institution's primary purpose is to finance government spending, manage debt and administer certain government pension funds. The purpose of the Treasury is to fund the government so that it can spend on real goods and services in the real economy.

What really matters here is not necessarily the total amount of government spending, but rather the deficit itself – because that deficit is financed by additional borrowing. It is one thing to extend the existing debt burden by issuing new securities, but quite another to keep increasing the debt to finance the delta between spending and tax revenues. If the deficit grows and is bought with bank reserves, then the amount of funds stuck in the TGA grows. Once these funds are spent in the real economy, they magically turn into bank deposits.

So the key here is not just higher spending, deficits and borrowing, but purchases of goods and services by the state. The TGA must be emptied.

Once the Treasury has crossed the event horizon and federal government spending is constantly needed to support economic growth, a hose is connected that feeds the Fed's liquidity heroin directly into the veins of the real economy.

This pipe grows and expands with budget deficits as the government's borrowing needs increase and the market is unable to fund it. Changes to money market funds in 2013 meant that they were forced to park much of their cash in high quality short-term liquid assets, namely treasury bills, to provide another source of funding for government borrowing. The same is true for banks that were subject to Basel regulations after the financial crisis, which shifted more of their capital into bills and bonds.

Currently, the US Treasury is being pushed deeper and deeper underwater. Absent a major financial crisis or recession, the US government's deficit for fiscal year 2023 is expected to be 5.8% of GDP – higher than 2022 and nearly double the 20-year average. Interest spending will rise to 1 trillion dollars for the first time this year. Tax revenues will fall by several hundred billion.

On October 3, 2022, the United States added \$275 billion in new debt in a single day!

ZeroHedge noted on October 18:

“The total U.S. debt is now \$33.669 trillion, an increase of \$58 billion in one day and \$604 billion in one month... an increase of \$20 billion every day, \$833 million every hour.

At this rate, the U.S. debt will be \$41 trillion in one year.”

Recently, the Treasury Department has primarily used bill sales to bolster its cash reserves and cover the growing budget deficit, especially since the suspension of the debt ceiling. As these debt securities mature, the Treasury pays them off by issuing new ones, rolling the debt forward, much like options or futures traders roll contracts from week to week or month to month.

The problem is that all these securities are refinanced at higher interest rates, adding more interest costs to the overall balance sheet. This leads to a massive increase in the interest expense paid by the United States.

As the interest rate increases, the amount of debt issued must increase by the same amount. This means that the total interest paid increases even more, further increasing the debt in a feedback loop. To make matters worse, this process is not linear, not only logically due to compound interest, but also due to other feedback loops.

The US government has been living on borrowed time for decades. The fact that it is the world's reserve currency has meant that there has been an artificial demand for government bonds and dollars for decades, allowing America to borrow cheaply and spend lavishly without having to pay for it immediately. Politicians, sensing this cheap money, have immensely expanded and increased entitlement and discretionary spending programs, which has increased the national debt and accelerated the spiral. When interest rates rise, the Federal Reserve raises interest costs for the Treasury, which leads to more borrowing, which leads to more bond issuance. This process is not linear, but exponential.

The tsunami of new government bond issuance is not funded by foreign central banks, and commercial banks have limited balance sheet capacity, as do retailers. Eventually, the Fed will be forced to resume QE.

This time, inflation will skyrocket as the liquidity hose is injected directly into the Treasury and thus into the real economy. Raising interest rates? Higher interest spending and more debt. Debt spiral. Emerging markets will be crushed. Lower interest rates? Higher bank lending and M2 growth. More inflation and debt spiraling in the private sector.

All of this matters because inflation depends on the amount of spendable money circulating in the economy – bank reserves are not spendable, but M2 (mainly bank deposits) is. As this process accelerates, more and more reserves are converted into M2 and thus into usable money supply, fueling inflation.

The Fed then faces its final dilemma: save the system or save the dollar. We know from history that they will do anything to ensure that the Treasury remains monetary in nominal terms. The markets will be forced to face a frightening mathematical certainty: There will be an exponential supply of Treasury bonds.

With massive bond issuance coming our way, holders will sell all the government paper they own, causing bond prices to fall and yields to rise further. To stop the bleeding, the Fed will have to use even more QE. Perhaps the Fed or the Securities and Exchange Commission can prohibit selling, but that would also eliminate the other side of the equation, buying. The US government bond market, like the Japanese market, would die a slow, suffocating death without liquidity.

Eventually, bond trading will only take place between dealers, the Treasury and the Fed. Only purchases will be allowed. The massive surplus of bank reserves created since 2008 would flow into the M2 money supply and lead to an increase in inflation and thus government spending.

This would expand the liquidity hose even further.

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